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SIPDIS

DEPT FOR AF/E, AF/EPS, EEB/IFD/OMA
DEPT ALSO PASS TO USTR FOR BILL JACKSON
DEPT ALSO PASS TO DEPT OF LABOR FOR MICHAL MURPHY, SUDHA HALEY,
PATRICK WHITE AND MAUREEN PETTIS
DEPT ALSO PASS TO USAID/EA
DEPT ALSO PASS TO USITC FOR RALPH WATKINS
TREASURY FOR VIRGINIA BRANDON
COMMERCE FOR BECKY ERKUL

SENSITIVE

SIPDIS

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TAGS: ECON EFIN ELAB ETRD EINV KE
SUBJECT: KENYA'S CENTRAL BANK GOVERNOR TOO OPTIMISTIC

REFS: (A) NAIROBI 383, (B) NAIROBI 380, (C) NAIROBI 353,

(D) NAIROBI 192

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¶1. (SBU) Summary: Kenyan newspapers disregarded the sugar-coating in Central Bank of Kenya (CBK) Governor Njuguna Ndung'u's claims that the impact of post-election violence would most likely be confined to the first quarter. They highlighted his admissions that there could be a major slowdown, that investors could postpone investments, and that the damage could be long-term, especially in the labor sector. Despite some internal contradictions, Ndung'u's statement made clear the CBK's primary goal is to keep underlying inflation within the 5% target to encourage long-term economic growth, and that the CBK will oppose an easing of monetary policy or encouraging higher interest rates because money supply growth is already well above target. He did not propose a strategy for addressing the crisis, saying the CBK and the government need more specific information from the banking sector before formulating policy. End summary.

Sugar-Coated CBK Governor's Press Release

¶2. (U) CBK Governor Njuguna Ndung'u responded to the dire warnings from private sector leaders that the current political crisis threatens to cut Kenya's 2008 growth down to 4%, or even zero, with an optimistic, four-page February 6 press release entitled, "Kenya Has Slipped, It Can Rise Again." Despite including a few caveats, he stressed the economic impact of the crisis would most likely be short-term. Ndung'u admitted the turmoil had destroyed factors of production, disrupted access to raw materials, disrupted distribution and supply channels, raised insecurity, displaced labor, caused fuel shortages, dented business and consumer confidence, and would cause delays in investment decisions. He admitted that GDP growth for 2008 may not reach the pre-crisis 8% projections because of the damage to tourism, manufacturing, agriculture, transport and communication. However, he predicted the political crisis would be short-lived, with damage limited to the first quarter, and that strong fundamentals would achieve growth, albeit slow, in 2008, rather than no growth at all.

Need More Info Before Precipitate Policy Making

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¶3. (U) Ndung'u said the CBK is still trying to quantify the economic costs of the political crisis, and is waiting for the banking sector to report the full extent of losses and possible write downs. When this information becomes available, he said the fiscal and monetary authorities would formulate a plan to handle this political-economic shock. He indicated the CBK would concentrate on keeping underlying inflation within the 5% target to encourage investment and promote long-term real economic growth, and not undertake precipitate policies to support the shilling, increase liquidity, or raise interest rates.

Media Ignorance is Not Reason To Intervene

¶4. (SBU) Ndung'u took advantage of the media's misplaced blame on "speculative attacks" as the cause of the shilling's depreciation to deride the media's analytical capacity and warn the public to be skeptical of calls for the CBK to intervene in the foreign exchange (forex) market. While he correctly blamed the depreciation on market expectations that future foreign exchange earnings will be constrained, he incorrectly claimed this was caused more by donors cutting off aid than by an expected decline in economic performance. Ndung'u tried to reassure markets by stating the CBK and commercial banks have plenty of foreign currency on hand. Official foreign exchange reserves at the end of December 2007 were $3.36 billion (equivalent to 4.8 months of imports), while commercial banks' held another $1.2 billion. He said the CBK is committed to stabilizing exchange rate movements only when they are driven by non-fundamental factors, rather than day-to-day volatility (in his words, "noisy trading").

Q1 High Inflation Reflects Only Temporary Supply Constraints
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¶5. Ndung'u stressed that increases in overall inflation such as the 18.2% rate in January were caused by temporary shortages caused by failed rains and ethnic unrest and violence in food surplus areas. He contended these short-run shocks do not represent fundamental changes, but acknowledged that sizable increases in food and energy prices might continue beyond the first quarter, erode real incomes, and be inconsistent with the objective of price stability. (Note: The CBK excludes food and energy prices from the underlying inflation rate it uses as its inflation target. End note.)

No Easing of Monetary Policy

¶6. (SBU) Although Ndung'u's statements on banking sector liquidity were internally inconsistent, he admitted the risk that commercial banks would have to repair balance sheets and restore capital, which could force them to restrict new lending, significantly affecting the level of economic activity. He maintained, however, that easing of monetary policy is not necessary and may not be appropriate because broad money growth increased massively in December in connection with election and holiday related spending, and increased further in January, as Kenyans increased their precautionary balances in times of uncertainty. Reserve money has been significantly above target, and must be contained to cut inflation. He argued that a reduction in the benchmark Central Bank Rate (CBR) might mislead the market to think "the CBK is focusing more on stabilizing demand than meeting the inflation target." He said the Monetary Policy Committee (MPC) would assess the medium-term outlook for inflation and the risks to demand and activity, in the short term.

Tribal Tension Threatens Kenyan Labor Market

¶7. (U) The one factor Ndung'u admitted would cause a long-term reduction in production was the disruption of workforces caused by tribal tensions. He warned that "ethnic cleansing" in various parts of the country had a direct negative effect on the economy. Ndung'u called for strong policy intervention to prevent the hiring of personnel based on location and ethnic group, rather than merit, from taking root in the labor market.

Comment

¶8. (SBU) It is understandable that Ndung'u feels obliged to minimize the economic crisis (ref D), but the press was not deceived, and its coverage emphasized the more dismal caveats in his press release.

Ndung'u would do well to speak more clearly, concisely, and realistically, acknowledging the private sector's warnings as valid if a political settlement is not reached quickly (ref C). We hope he is being more upfront with political leaders. Ndung'u is a good economist and a good Embassy contact, and the CBK governor plays an important role in Kenya's macro-economic management. However, the tightrope between acknowledging reality and maintaining morale that any government economic official has to walk in such a crisis is difficult. Ndungu's cheerleading threatens to weaken the credibility he will need over the coming months as the GOK tries to manage the economic fallout of the crisis.

RANNEBERGER